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SUBJECT: Prospectus Directive: Final Adoption is Milestone  
- Important Details to Follow: Possible Requirement for US  
Firms to Use IAS a Huge Issue

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Ref: A) Brussels 3470; B) Frankfurt 2582

1.(SBU) Summary: Adoption of the Prospectus Directive in July by the European Parliament (ref A) and Ecofin Council is a milestone event in the EU's Financial Services Action Plan. The text was much improved over the European Commission's initial proposal and solved the major question of "issuer choice" to the satisfaction of the banking and primary dealer community. A host of other issues, however, are still to be solved in the implementation process. The Committee of European Securities Regulators (CESR) has produced its final advice to the Commission on the minimum information requirements for a prospectus. This was also not an easy process, as CESR's initial proposal was heavily criticized as too cumbersome and detailed.

2.(SBU) A major issue for non-EU issuers will be whether home country accounting standards, such as US GAAP, can be used instead of International Accounting Standards (IAS), as endorsed by the EU, as required for EU firms listed on stock exchanges. Such a requirement, or even requiring reconciliation of US GAAP to IAS could be very expensive and could drive some US issuers out of the European markets in which they currently list or offer their securities for sale. Now that would not be in keeping with the EU's objective of creating a strong European capital market, would it? US officials have raised the issue with DG Internal Market officials who concede that such a policy would be like shooting themselves in the foot. In a new consultation paper, CESR states that the question is still open, but proposes that large, wholesale debt issuers may not have to use IAS or reconcile their accounts. End Summary

Adoption of the Prospectus Directive: A Long and Windy Road  
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3.(SBU) Following behind the scenes negotiations among key officials of the European Commission, European Parliament and member state Finance Ministries, the European Parliament on July 2 adopted the proposed Prospectus Directive (ref A). The Council adopted the directive on July 15. The directive represents the end result of a hard-fought and contentious effort to introduce a "single passport" for issuers of securities, allowing them to use a prospectus approved by one member state competent authority in all other member states. Member States have 18 months to transpose the directive into national legislation.

4.(SBU) Commissioner Bolkestein hailed the agreement as demonstrating that the Commission, Council and Parliament can overcome initial differences of views "through a constructive spirit of compromise." Not known for his mastery of the understatement, this one is a beauty. The Commission's initial proposal of May 2001 was thoroughly trashed as a terrible example of legislative drafting. Rather than consulting with market experts, a senior DG Internal Market official plead that time was pressing and they needed to issue a draft quickly. (In retrospect, he conceded that the document was poorly drafted and submitted in haste to make progress on the Financial Services Action Plan.)

5.(SBU) Parliament proposed over 65 amendments, essentially re-writing the text. The Commission "modified" its proposal in August 2002, incorporating many of Parliament's changes. The Council also had a difficult time wrestling with issues of language, application to sovereign issues and whether authority to approve prospectuses could be delegated to exchanges.

6.(SBU) One major issue for investment firms and issuers of non-equity securities in particular was whether issuers they could chose the competent authority to approve their prospectus. In the current euro bond market, issuers of debt securities can have their issue approved in London or Luxembourg, markets where they intend to offer the debt issue for sale, rather than in their home market. Several member states opposed such "issuer" choice. In the end, the final text will permit issuers of non-equity securities in denominations of at least euro 1,000, to be able to choose the competent authority to review and approve their prospectus.

7.(SBU) In a joint statement, the Banking Federation of the European Union (FBE) and the International Primary Market Association (IPMA) declared that finalization of the directive "marks the success of a tremendous effort by the financial services industry to make its voice matter in the political process of structuring a "passporting" system." They went on to state that "the financial services industry notes with satisfaction that issuers of more than 90% of all bonds will have the right to determine where to file their prospectus, as they do today, and that debt issuance programs, or Medium Term Notes (MTNs), a structure which is now used by 90% of international debt issues, will continue to operate."

8.(SBU) All is not well, however. FBE/IPMA still has "some substantive concerns." Among these is that convertible bonds will be categorized as equity and subject to more stringent requirements than at present, that the definition of qualified investor (e.g. professional investor) is not clear; and high translation costs for cross-border issues (the summary may have to be translated into the host country's language). They note that some securitized derivatives will have to be discontinued. Several investment bankers complained about information requirements imposed on non-equity issues, since a lighter information regime would apply only to issues in denominations of euro 50,000 or more. Such changes will alter the present operations of the euro bond market, in their opinion.

9.(SBU) The compromises, however, were hard fought. Indeed, up to the last day in the plenary a German Finance Ministry official thought that an aggressive push in Parliament to give all issuers investor choice could allow the French to re-open the entire issue rather than fixing on a compromise. Commented a Parliamentary staffer: "We got what we could, but couldn't get everything."

Important Details: Enter CESR

10.(SBU) Passage of the directive provides "framework" legislation that needs to be filled in with details by the European Commission based on advice from CESR. This is tough, technical sloggng. CESR began to develop details already in March 2002 when the Commission gave it its first mandate on the prospectus directive. The text of the directive has changed since then, giving CESR somewhat of a moving target.

11.(SBU) CESR's first a consultation document was a flop (ref B). It demanded many details, many of which were considered inappropriate, particularly for bond issues. The format for documentation was considered cumbersome and overly rigid for a market place in which new financial instruments can be engineered overnight.

12.(SBU) To its credit, CESR took these criticisms to heart. It held public hearings and listened to industry representatives. On July 31 CESR issued its advice to the European Commission on (a) disclosure obligations (e.g. for equity securities, retail and wholesale debt, asset-backed securities, etc.); (b) incorporation by reference of previously published information (e.g. annual reports); and (c) publication of a prospectus (availability, contents of a notice, methods of publication (e.g. email). CESR noted that it had reduced information requirements, particularly for debt issues, and used existing IOSCO standards, which had been developed without much public consultation, as a benchmark rather than as minimal standards. One bond expert who had participated in consultations with CESR reported that the initial sessions were highly confrontational. By the time of the last consultation in June he said it was "a love feast." This is not to say there has been complete satisfaction with all details. But CESR work has improved as a result of its consultation process.

13.(SBU) Bond representatives might have won that skirmish. But a major potential battle looms.

Accounting and Auditing Standards: Content of a Prospectus

14.(SBU) An issue that arose in the first round of

consultations with CESR was the use of accounting and auditing standards. Under the EU Regulation on international accounting standards, all EU companies listed on exchanges will have to have their accounts prepared according to IAS, as endorsed by the European Commission, as of financial year 2005. CESR's initial consultation document implied that accounts would have to be prepared using IAS and International Standards of Audit (ISA), but was not clear.

15.(SBU) CESR issued a new consultation document at the end of July that is more explicit. It proposes including "two years of audited historic financial information prepared and presented in accordance with the accounting standards which will be adopted in the issuer's next annual financial statements." That would mean re-stating two years of information according to IAS. CESR considered and rejected other options: re-statement of three years of accounts; reconciliation between local Generally Accepted Accounting Principles (GAAP) and IAS, and no restatement or reconciliation. CESR has invited comments on this consultation document by October 30 and will hold hearings on October 9 in Paris. It will provide its final advice to the Commission by 31 December.

16.(SBU) On auditing standards CESR acknowledges that the absence of comprehensive rules at the EU level could result in differing levels of audit scrutiny of accounts. CESR declared, however, that it shares the European Commission's objective to implement International Standards of Audit (ISA) as of 2005.

#### Issuers from Third Countries: The Meaning of Equivalence

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17.(SBU) Issuers from third countries were among the most outspoken critics of CESR's initial consultation paper. One such critic was the American Financial Services Association (AFSA). AFSA is a trade association that represents 400 firms involved in the financial services industry including Ford Motor Credit Company, GMAC Financial Services, CIT Group Inc., Household International and Toyota Motor Credit. AFSA states that these borrowers have debt outstanding totaling approximately \$224 billion listed in the EU. These companies issued \$37 billion of corporate securities listed on an EU exchange in 2002, and \$71 billion in 2001.

18.(SBU) AFSA argues that US GAAP should be considered to be international accounting standards since they are prevalent in the international market place and require comparable disclosure as EU rules. Therefore, U.S. GAAP accounts "should be acceptable under the Directive."  
"Requiring issuers to restate US GAAP numbers to a different international accounting standard on an ongoing basis would impose costs so prohibitively high as to drive many issuers out of the European debt capital market." AFSA made the same case for the use of auditing standards and "invited" CESR and the Commission "to make clear that U.S. audit standards represent equivalent standards" to those in the EU.

19.(SBU) In July CESR issued a new consultation paper in July regarding (a) minimum information requirements for sovereign government securities issues, should authorities decide to issue one (non-equity issues and guarantees by such governments are not required to draw up a prospectus); (b) historical financial information of EU and non-EU issuers to be included in a prospectus; and (c) advertising. With respect to (b) CESR proposes that non-EU issuers be subject to the same minimum information requirements as EU issuers. Non-EU issuers that prepare financial statements according to a GAAP "equivalent" to IAS Regulation need not submit additional information.

20.(SBU) CESR acknowledges that their proposal raises the question of "equivalence." Article 20 of the Prospectus Directive specifies that a competent authority in a member state may approve a prospectus from a third country issuer provided that the prospectus has been drawn up in accordance with international standards (e.g. IOSCO Disclosure Standards) and the information requirements, including information of a financial nature, are "equivalent" to the requirements under this Directive. The Commission is authorized to adopt implementing measures stating that a third country ensures such equivalence.

21.(SBU) CESR states in its July consultation document that it is working with the European Commission in order to devise the best procedure to "manage the question of equivalence." A German securities official suggests that EU securities regulators tend to believe that accounts prepared under U.S. GAAP should be considered equivalent to IAS accounts. This official points out that all major European exchanges do so now. The European Commission, according to this official, is in a dilemma: they want

companies to abide by the new regulation on international accounting standards rather than use US GAAP, as some firms now do. Resolution of this issue is not a technical matter but a political one, in official's opinion.

22.(SBU) DG Internal Market officials have not made a clear public statement on this issue. They have declared that an overall goal should be to achieve convergence between U.S. GAAP and IAS. They would like EU issuers to be able to use accounts prepared using IAS for listing in the United States. USG officials have raised the use of accounts prepared under U.S. GAAP in the informal US-EU financial market dialogue. In response, DG Internal Market officials conceded that not accepting US GAAP would damage the EU capital market should US issuers leave. "We would shoot ourselves in the foot," quipped one. They reportedly made the same comment to representatives of AFSA.

23.(SBU) Some members of the finance industry, however, believe that the Commission is using this issue as a bargaining lever to extract concessions from the US, such as on implementation of Sarbanes-Oxley legislation or placement of European trading screens in the United States, a "tit-for-tat" approach to regulation.

#### The Power of an Exemption

24.(SBU) In its July consultation paper CESR proposes some exemptions for wholesale issuers from having to meet an "equivalence" standard. CESR reasons that the different nature of the investors concerned justifies different treatment. This exemption would apply to both accounting and auditing standards for wholesale debt issues and issuers of high denomination asset backed securities or depository receipts (e.g. issues having denominations of at least euro 50,000).

25.(SBU) Specifically CESR proposes that issuers are to use accounts prepared under IAS or a non-Member state local GAAP equivalent to IAS, "otherwise" the following information shall be included in the registration document: (a) "a prominent statement that the financial information included in the registration document has not been prepared in accordance with IAS Regulations and that there may be material differences in the financial information had IAS Regulation been applied to the historical financial information; (b) immediately following the historical financial information a narrative description of the differences between IAS Regulation and the accounting principles adopted by the issuer in preparing its annual financial statements. Similarly, if different auditing standards were used than those applicable in a member state, information shall be included would be (a) a prominent statement disclosing which auditing standards have been applied; and (b) an explanation of any significant departures from ISA.

#### CESR Information Gathering

26.(SBU) In January the Commission gave CESR a mandate to provide factual information and legislative and practices of Member States regarding the treatment of third country issuers with respect to drawing up and approval of prospectuses. This information is due to the Commission at the same time CESR provides its advice on the July consultation document, that is, 31 December. On the basis of the information gathered the Commission will decide whether an additional mandate asking CESR to provide technical advice on possible draft implementing rules will be granted in the future.

#### An Observation

27.(SBU) Accounts prepared under U.S. GAAP were once considered the world standard. EU firms listed on US exchanges had to use U.S. GAAP accounts or reconcile them to it. Even EU firms listed on US exchanges could use their U.S. GAAP accounts to satisfy home country requirements. The EU Regulation on international accounting standards is changing all that. By forcing uniformity of accounting standards for all 7,000 EU listed firms, it raises the prevalence of IAS usage. This has the potential to divide the world in two: IAS and U.S. GAAP. In August the Swiss Stock Exchange announced that as of 2005 only IAS or U.S. GAAP accounts would be accepted for Swiss listed firms on its exchange: Swiss GAAP will no longer be accepted. In July the German Accounting Standards Board made cooperation with the International Accounting Standards Board (IASB) its primary objective.

28.(SBU) Bringing these two accounting standards worlds together is noble aim of the convergence project of the U.S. Financial Accounting Standards Board and the International Accounting Standards Board. Former SEC Chairman Pitt stated that if there were sufficient progress in convergence and a process for consistent interpretation and enforcement of IAS, then it may be appropriate for the SEC to reconsider the need for private issuers from the EU firms to continue to reconcile from IAS to U.S. GAAP. A Commission statement to the same effect would go a long way toward relieving market uncertainties its current ambiguous position is creating.

29.(SBU) By keeping the issue vague of whether US firms can continue to use U.S. GAAP in Europe, the Commission thinks it keeps up the pressure for firms in the EU to use Commission-endorsed IAS and convergence, the latter seen as an ultimate objective by Commissioner Bolkestein. There are other views of the Commission's objectives. One is that it would like to assert the primacy of EU standards world wide - a counterweight to the role of the U.S. SEC. Another is that, as noted above, the Commission wants to use the acceptance of U.S. GAAP accounts as leverage for other concessions.

30.(SBU) If convergence truly were the Commission's goal, it could enlist the firms represented by AFSA to push for such convergence. Such convergence would unite two major capital markets. If the other two views more accurately reflect reality, then the outcome depends on politics. This may or may not be at all helpful for financial markets. What is less uncertain, is that by maintaining uncertainty, the Commission is needlessly creating uncertainties for non-EU global firms that may take their business elsewhere. It wouldn't be the first time that financial markets, provoked by policy changes, created new instruments and markets were none had existed before.

31.(U) This cable coordinated with Embassies Berlin, Rome, The Hague and USEU Brussels.

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